FILE COPY

Office Supreme Court
FILED
OCT 15 19
CHARLES ELMORE

No. 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

versus

HENRY HARMEL, *Respondent*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

ROBERT ASH,
WASHINGTON, *D. C.*,
Attorney for Respondent.

A. H. BRITAIN,
LESLIE MARTLEW,
HARRY C. WEEKS,
WICHITA FALLS, TEXAS,
Of Counsel.

BAILEY-WICHITA FALLS

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes involved	2
Statements	5
Summary of Argument	8
Argument	12
Preliminary Statement	12
I. The terms "sale or exchange" and "property" in the Statute are not defined. Their meaning under general law is well understood. We turn, therefore, to the law of Texas and find that the instruments in question were sales of the oil in place. This meets the statutory test. Under every jurisdiction the rights conveyed are property. The distinctions drawn in the Group No. 1 and the Coronado Oil & Gas Company cases, recently decided, require these "leases" to be recognized as sales	13
II. It is clear from the treatment of such instruments for stamp tax purposes and for depletion, that Congress clearly understood that such instruments constituted present sales	34
III. It is admitted that the sales in question constituted taxable income. No question of Congressional power is involved. Hirschi v. U. S., by the Court of Claims, was wrongly decided, Stratton's Independence and related cases, Work v. Mosier and Burk-Waggoner v. Hopkins do not control. Instead the principles of Group No. 1 Oil Corporation, Coronado Oil & Gas Company, the Community Property Income Tax Cases and Crooks v. Harrelson, and other cases, should be applied to the law of Texas	39
Conclusion	70
Appendix	72

Page

AUTHORITIES CITED

Cases

Alexander v. King, 46 Fed. (2d) 235 ..... 27, 60

Bankers Pochontas Oil Co. v. Burnet,
55 Fed. (2d) 626 ..... 11, 61, 63
Benavides v. Hunt. 79 Tex. 396..... 22, 23, 26
Bender v. Pfaff, 282 U. S. 127 ..... 9, 11, 17, 45
Berg v. Commissioner, 33 Fed. (2d) 641 60
Brushaber v. Union Pacific Ry. Co., 240 U. S. 1.... 44, 53
Burkett v. Commissioner of Internal Revenue,
31 Fed. (2d) 667 59
Burk-Waggoner Oil Ass'n v. Hopkins,
269 U. S. 110..... 11, 41, 42
Burnet v. Coronado Oil & Gas Co., 284 U. S. 606 10, 11, 26
Burnet v. Houston, 283 U. S. 223 65
Burnet v. Logan, 283 U. S. 404 65

Cambell v. Schrock, 10 S. W. (2d) 165..... 24
Castillero v. U. S., 2 Black 169, 17 L. Ed. 380..... 28
Crooks v. Harrelson, 282 U. S. 55..... 11, 33, 42, 47

DeVaughn v. Hutchinson, 165 U. S. 566 17

Ehlinger, County Judge v. Clark, 117 Tex. 547..... 22
English v. Plumley, 291 S. W. 922 25
Eldorado Coal & Mining Co. v. Mager 255 U. S. 522.. 44

Ferguson v. Commissioner, 45 Fed. (2d) 573 11, 15, 25, 70
First Trust Company of Omaha v. Allen
51 Fed. (2d) 1069 .....42, 47
Five Per Cent Cases, 110 U. S. 421..... 15
Forbes v. Gracey, 94 U. S. 762, 24 L. Ed. 313.....14, 27

Gladys-Belle Oil Co. v. Turner, 12 S. W. (2d) 872.... 25
Goddell v. Koch, 282 U. S. 118 ..... 9, 17, 45
Goodrich v. Edwards, 255 U. S. 527..... 44
Gowan v. Christie, 5 Moak 114 12
Gray v. Darlington, 15 Wallace 63 44
Green v. Priddy, 112 Texas 567 24
Group No. 1 Oil Co. v. Bass, 283 U. S. 279...10, 11, 19, 26

Hager v. Stakes, 116 Texas 453 24
Henn v. Commissioner, 20 B. T. A. 1133 27
Hines Yellow Pines Trustees v. Martin,
268 U. S. 458 .....16, 20
Hirschi v. U. S., 67 Court of Claims 637 ..10, 40, 42, 43, 59

Page

Hopkins v. Bacon, 282 U. S. 122 ..... 9, 11, 17, 45

Leser v. Burnet, 42 Fed. (2d) 756 ..... 11, 66
Ludey v. U. S., 274 U. S. 295 49
Lynch v. Alworth-Stephens Co., 267 U. S. 364 ..... 14, 27
Lynch v. Turrish, 247 U. S. 22 44

Merchants Loan & Trust Co. v. Smietanka,
255 U. S. 509 44
Murphy v. Commissioner, 9 B. T. A. 610 15
Murphy Oil Co. v. Commissioner, 15 B. T. A. 1195 ... 31

Phillips v. Commissioner, 283 U. S. 589 51
Poe v. Seaborn, 282 U. S. 101 ..... 9, 17, 45, 51

Reynolds v. Commissioner, 10 B. T. A. 651 15
Rosenberger v. McCaughn, 25 Fed. (2d) 699 ..... 11, 61

Samet v. Farmers & Merchants Nat'l Bk. of Baltimore
(C. C. A.) 247 Fed. 699 14
Sanload v. U. S., 4 Peters, 511 14
Southern Oil Co. v. Colquitt, 69 S. W. 169 ..... 24, 26
Southern Pacific Ry. Co. v. Lowe, 247 U. S. 330 44
Stanton v. Baltic Mining Co., 240 U. S. 103 ..... 11, 44, 53
Steedman v. U. S., 63 Court Claims 226 ..... 41, 42
Stephens County v. Mid-Kansas Oil & Gas Co.,
113 Texas 160 ..... 18, 23, 24, 25, 26
Stephens v. Stephens, 292 S. W. 290 25
Stratton's Independence v. Howbert,
231 U. S. 399 ..... 11, 40, 43, 51

Texas Company v. Daugherty, 107 Texas 226 ..... 18, 26
Theisen v. Robinson, 117 Texas 489 ..... 18, 22, 26, 28
Thompson Oil & Gas Co., v. U. S., 283 U. S. 301 49
Tyler v. U. S., 281 U. S. 497 ..... 11, 67

United States v. Biwabik Mining Co., 247 U. S. 116. 11, 54
United States v. Cambridge Loan & Bldg. Co.,
278 U. S. 55 ..... 11, 33, 48
United States v. Malcolm, 282 U. S. 792 .. 9, 11, 17, 18, 45, 47
United States v. Michel, 282 U. S. 656 46
United States v. Robbins, 269 U. S. 315 ..... 11, 17, 47
United States v. Updike, 281 U. S. 489 46

Von Baumbach v. Sargent Land Co., 242 U. S. 503 .. 11, 53

Waggoner Estate v. Sigler, 118 Texas 509 ..... 22, 25, 26
W. T. Waggoner Estate v. Wichita County,
273 U. S 113 ..... 17, 24
Walsh v. Brewster, 255 U. S. 536 44

Page

Warburton v. White, 176 U. S. 484 17
Weiss v. Weiner, 279 U. S. 333 ..... 11, 48
White v. Murphy, 229 S. W. 641 25
Williamson v. Berry, 8 Howard 495 ..... 15, 34
Work v. Mosier, 261 U. S. 352 ..... 11, 56

Statutes

Revenue Act of 1924 (ch. 234, 43, Stat. 253, 262)
Sec. 208 ..... 2, 13
Revised Statutes of Texas, 1925, Arts. 5473-5479 25
Title IX. Sec. 1100, Schedule A (7)
Revenue Act of 1918 ..... 31, 35
Title XI. Sec. 1100, Schedule A (6)
Revenue Act of 1921 ..... 31, 35
Title VII. Sec. 1100, Schedule A (5)
Revenue Act of 1924 ..... 31, 35
Section 725 Revenue Act of 1932 31
Revenue Act of 1918, Sec. 214 (a) (10) 35, 36
Section 213 Revenue Act of 1924 44

Treasury Regulations and Rulings

IT 2169, Cum. Bull. IV-1, page 13 27
IT 2524, Cum. Bull. IX-1, page 199 14
G. C. M. 913, Cum. Bull. V-2, page 255 32
G. C. M. 2367, Cum. Bull. VI-2, page 172 14
Regulations 65, Articles 201, 203, 216 .... 30, 31, 72, 73, 74
Regulations 71, Article 84 75
S. M. 4439, Cum. Bull. IV-2, page 52 32
Treasury Decision 3938, Cum. Bull. V-2, page ____ 31, 74

Other Authorities

Lindley on Mines (2nd edition) Sec. 5, pp. 9 and 10,
Sec. 9, pp. 14 and 15 ..... 28, 29
Thuss on Texas Oil and Gas, Sec. 46, p. 68 40
H. R. 350, 67th Congress, 1st Session, pp. 10-11
(Report of Committee on Ways and Means) 29
Senate Report No. 275, 67th Congress,
1st Session, pp. 12-13 30

No. 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

versus

HENRY HARMEL, *Respondent*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR RESPONDENT

(All *italics* throughout are ours, unless otherwise noted).

Opinions Below

This case originated in the United States Board of Tax Appeals. That Board's decision is reported in 19 B. T. A. 376. The opinion of the United States Circuit Court of Appeals for the Fifth Circuit (per Bryan, Circuit

Judge) is reported in 56 Fed. (2d) 153. Certiorari was granted April 18th, 1932, 52 Sup. Ct. 498.

Jurisdiction

The judgment of the Fifth Circuit Court of Appeals was entered Feb. 23, 1932 (R. 21). The petition for certiorari was filed March 24th, 1932, and was granted April 18, 1932. (R. 22). The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented

The Respondent, in 1924, executed and delivered two oil and gas leases on lands in Texas for cash considerations, which admittedly constituted taxable income. The question presented is whether this taxable income was gain derived from the sale or exchange of capital assets, as that term is defined in Section 208 of the Revenue Act of 1924, and therefore taxable at the flat rate of 12 1-2 per centum imposed by this Section, or must this gain be classified as ordinary income, subject to the progressive normal and surtax rates imposed by Sections 210 and 211 of said Revenue Act?

Statutes Involved

Revenue Act of 1924:

"Sec. 208 (a). For the purpose of this title—(1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term 'capital loss' means deductible loss resulting from the sale or exchange of capital assets;

(3) The term 'capital deductions' means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;

(4) The term 'ordinary deductions' means the deductions allowed by section 214 other than capital losses and capital deductions;

(5) The terms 'capital net gain' means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term 'capital net loss' means the excess of the sum of the capital losses plus the capital deductions over the total amount of the capital gain;

(7) The term 'ordinary net income' means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term 'capital assets' means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12 1-2 per centum of the capital net gain.

(c) In the case of any taxpayer (other than a corporation) who for any taxable year sustains a capital net loss, there shall be levied, collected, and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount minus 12 1/2 per centum of the capital net loss; but in no case shall the tax under this subdivision be less than the taxes imposed by sections 210 and 211 computed without regard to the provisions of this section.

(d) The total tax determined under subdivision (b) or (c) shall be collected and paid in the same manner, at the same time, and subject to the same provisions of law, including penalties, as other taxes under this title.

(e) In the case of the members of a partnership, of an estate or trust, or of the beneficiary of an estate or trust, the proper part of each share of the net income which consists, respectively, of ordi-

nary net income, capital net gain, or capital net loss, shall be determined under rules and regulations, to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership or estate or trust, and shall be taxed to the member or beneficiary or to the estate or trust as provided in sections 218 and 219, but at the rates and in the manner provided in subdivision (b) or (c) of this section."

Statement

Respondent, Henry Harmel, resided in Texas. In October, 1924, he had owned for many years certain lands in Archer County, Texas. (R. 8-14-17). On October 13, 1924, he executed an oil and gas lease to one E. R. Fain covering a portion of this land for a cash consideration; and, on October 21, 1924, he executed another such lease to one J. A. Gardner, for a cash consideration, covering another portion of said land (R. 14-17).

The cash considerations so received totaled $57,000.00 (R. 8). This sum was reported by the Respondent in his 1924 income tax return as "capital gain" subject to taxation at 12 1/2 per centum (R. 9). The Petitioner, upon auditing this return, held that this sum was ordinary income and, by virtue of the change, determined that Respondent was liable for an additional tax (R. 3-5). From this determination, Respondent appealed to the United States Board of Tax Appeals (R. 2), and the issue thereby presented has been brought, by the customary procedure, to this Court for determination.

The oil and gas leases in question are set out in full

in the record. (Fain lease, R. 14-17; Gardner lease, R. 17-19).

These instruments appear to be along the usual lines in use in the Texas Oil Fields. The terms of the Fain lease may be summarized as follows:

Consideration:[1] $20,000.00 cash, receipt of which was acknowledged, "the covenants and agreements" later set out, to be performed by Fain, and "other considerations" which the instrument discloses (R. 17) to be the further sum of $20,000.00 to be paid out of 1-2 of 7-8ths of the first oil produced. (R. 14).

Granting Clause: "Has granted, demised and let * * * unto the said lessee for the sole and only purpose of mining and operating for oil and gas and of laying pipe lines, power stations and structures thereon to produce, save and take care of said products." (R. 14-15).

Land Covered: Forty (40) acres. (R. 15).

Term: Three (3) years from date, and as long thereafter as oil or gas, or either, is produced from the land by lessee. (R. 15).

Lessee's Covenants and Agreements:

---

[1]A consideration of these instruments will refute the statement contained in Petitioner's brief under "Question Presented" (page 2 thereof) and reiterated in other places that these sums were paid "as advance royalties." It is entirely clear from an examination of the instruments that the cash payments were in nowise dependent upon the production of oil, and that the royalty provisions of the instrument are entirely separate and distinct from the consideration.

Royalties: 1-8th of the oil produced and saved, delivered in the pipe line, free of cost.

1-8th of the value of the gas produed from gas wells;

1-8th of the value of casinghead gas (gas from oil wells. (R. 15).

Drilling Obligations: To begin the drilling of a well within one year or pay an annual rental of $2.00 per acre per year; to resume development or delay rental payments within one year after a dry hole was completed. (R. 15-16).

Miscellaneous Covenants: To pay damages to growing crops, bury pipe lines, etc. (R. 16).

Further Terms: Warranty of title by Harmel, with subrogation clause against mortgages, taxes, etc.; express grant of the privilege of assignment by either party, etc.; grant to lessee of right to remove machinery, etc., and other standard provisions. (R. 16).

The Gardner lease (R. 17-19) follows, substantially, the terms of the Fain lease. The following variations (which, it is submitted, are without significance) will be noted:

Consideration: $44,000.00 cash, the customary covenants and agreements, and a further payment of $44,000.00, out of 1-2 of 7-8ths of the first oil produced, secured by the vendor's lien upon the estate granted. (R. 17-19).

Granting Clause: "Has granted, conveyed, demised, leased and let, etc." (R. 17).

Land Covered: Eighty (80) acres. (R. 17).

Miscellaneous Agreements: Express agreement to drill two wells, on penalty of termination, etc. (R. 19).

SUMMARY OF ARGUMENT

I.

Under the Statute (Sec. 208), Respondent is entitled to the application of the capital gain rate, if he made a "sale or exchange" of "property" held by him for more than two years. These conditions have been fulfilled because:

(a) Admittedly, the property in question had been held more than two years and the other limitations of subdivision (a) (8) of Section 208 have no application.

(b) Congress did not limit either the term "property" or the term "sale or exchange" so that the meaning of these terms is to be found in the general law. Under such law "property" is a term of very broad signification, embracing everything that has exchangeable value or goes to make up a man's wealth, every interest or estate which the law regards of sufficient value for judicial recognition; while a sale is ordinarily "a transfer of property for a fixed price in money, or its equivalent." Nothing in the Revenue Act warrants placing any limitation upon the ordinary meaning of these terms.

(c) The laws of Texas, in which State the transaction took place and the land was situated, govern in determining what interest Harmel had in the minerals in and under his land; and what interest was conveyed by the instruments in question.

(d) Under Texas law, oil and gas in place are a part of the real estate belonging to the fee owner; and the execution of the instruments in question constituted present sales to the lessees of the oil and gas in place; the estate conveyed was a determinable fee; these holdings constitute rules of property in Texas.

(e) The above holdings do not constitute mere terminology; but, under Texas law and decisions, the vital attributes which ordinarily follow such estates attach in full measure to the determinable fee granted by such an instrument. Texas rules regarding operation, conveyancing, taxation, etc., support this.

(f) Apart from Texas property rules, the interest of the land owner in oil and gas in place is everywhere recognized as a valuable property right, and the transfer of such right to an operator for a cash consideration, in addition to stipulated royalties, is a "sale or exchange" under the statute, requiring the application of the capital gain tax rate to the profit from the transaction.

(g) These conclusions are supported and required by (1) the legislative history of the capital gain section, (2) the departmental construction and interpretation of related sections of law, particularly as to the stamp tax upon leases, and the rules regarding depletion, (3) the relation of state rules of property to Federal Taxing Acts, exemplified by the *Community Property* decisions of this Court,[1] and similar cases, and (4) by the distinctions

---

[1]*Poe v. Seaborn*, 282 U. S. 101; *Goodell v. Koch*, 282 U. S. 118; *Hopkins v. Bacon*, 282 U. S. 122; *Bender v. Pfaff*, 282 U. S. 127; *U. S. v. Malcolm*, 282 U. S. 792.

drawn by this Court in the *Group No. 1*[1] and *Coronado* cases,[2] recently decided.

II.

That Congress clearly understood that oil and gas "leases" constituted sales is shown by its repeated approval of the Department's holding subjecting them to stamp taxes, and the treatment of the consideration as cost for depletion purposes.

III.

The questions involved should not be beclouded with issues not in the case. It is admitted by both parties that the sum in question is taxable income—that such income was derived from the conversion of capital assets does not affect this—and, therefore, questions as to what is and what is not income, long since settled by this Court, have no bearing upon the issues here involved. Likewise, the powers of Congress in the selection of objects of taxation are not questioned. Our inquiry is as to what Congress *has* done. We do not contend that Congress could not have excluded transactions like those involved from the benefits of the Capital Gain Section had it seen fit to do so.

Hirschi v. United States was wrongly decided because the Court of Claims erroneously construed the taxpayer's position as an attempt to limit the Federal taxing power by State property rules, and failed to rec-

---

[1]*Group No. 1 Oil Corporation v. Bass*, 283 U. S. 279.
[2]*Burnet v. Coronado Oil & Gas Company*, 284 U. S. 606.

ognize that Congress had, by the language used, made such State rules the test of whether a sale had taken place. Likewise, that Court wrongly held that the case was ruled by *Stratton's Independence v. Howbert; Stanton v. Baltic Mining Company; U. S. v. Biwabik Mining Company* and *Von Baumbach v. Sargent Land Company.*

These last named cases, as well as *Work v. Mosier,* have no bearing upon the question presented here.

Weiss v. Weiner; Burk-Waggoner v. Hopkins; Rosenberger v. McCaughn and *Bankers' Pocahontas Coal Company v. Burnet* are clearly distinguishable from the case at bar.

The true rules to be applied, in relating State property rules to Federal tax problems, are those announced and applied by this Court in the *Group No. 1 Oil Corporation,* the *Coronado Oil & Gas Company* cases and the *Community Property Income Tax* cases, in *Crooks v. Harrelson; U. S. v. Cambridge Loan & Building Company,* and in *Tyler v. United States.* An excellent example is *Leser v. Burnet,* 46 Fed. (2d) 756, by the Fourth Circuit.

In every case where the Statute makes the incidence of the tax depend upon the ownership of, powers over, or transfers of property, State law must be looked to to determine whether a transfer has taken place, who owns the property and what powers any one can exercise over it.

IV.

The Circuit Court of Appeals for the Fifth Circuit correctly applied these rules in deciding the same ques-

tion in *Ferguson v. Commissioner*, 45 Fed. (2d) 573, involving the identical question, and in the case at bar, and that Court's judgment should be affirmed.

ARGUMENT

Preliminary Statement

The basic question involved in this case is identical with that decided in favor of the application of the Capital Gains Section by the Fifth Circuit Court of Appeals in the case of *Ferguson v. Commissioner*, 45 Fed. (2d) 573. No further action was taken by the Government in that case, but the Court below was asked in this case to reverse its prior ruling. For this reason, the views of the Court below upon the question will be found to be much more fully stated in the Ferguson decision than in the opinion rendered in this case.

We believe it may be fairly said that the greater part of the difficulty which has apparently surrounded the question has arisen from the fact that the term 'lease' in connection with oil and gas is a misnomer, but has been so long used as to become practically a trade term.

It was early said in England:

> "What we call a mineral lease is really, when properly considered, a sale out and out of a portion of the land." *Gowan v. Christie*, 5 Moak 114, per Lord Cairns.

Certainly the effect of the language used, and not the name given the instrument, is the determining factor. See Thornton on Oil & Gas (1932), Sec. 77, p. 127.

A.

Since it is clear that Harmel owned the land in question for more than two years, that it was not held primarily for sale in the course of his trade or business, and was not of a kind properly to be included in inventory (Sec. 208 (a) (8)), our problem is simply whether Harmel, by the instruments in question, sold property.

By Sec. 208 (a) (8), a "capital asset" is "property" held by the taxpayer for more than two years, the limitation contained in subdivision (a) (8) having, as above stated, no present application. A "capital gain" is taxable gain from the "sale or exchange" of such a capital asset. If a taxpayer receives a "capital gain," subdivision (b) of Section 208 gives him the election of having such gain taxed at 12 1-2 per cent, rather than at the progressive rates provided in Sections 210 and 211.

Nowhere in the Act has Congress sought to limit the very general terms used. We have only to find the meaning of "property" and "sale or exchange" under general law and then turn to the laws of Texas, in which State the transaction took place and the land in question was located, to determine whether the interest which Harmel had in the subject matter of the transaction constituted "property" within the general definition, and, by the same standard, whether the transactions between Harmel and Fain, and Harmel and Gardner, constituted sales or exchanges.

Under the decisions of this, and all other courts, and in common parlance, "property" is a word of the broadest meaning. It embraces every right, interest or estate

which the law deems of sufficient importance to protect.[1] Regardless of the divergent views of Courts as to the exact estate which a fee owner has in the oil and gas, as well as solid minerals, in or under his land, it is everywhere admitted that his interest therein is a valuable and merchantable right, or property.[2] So, without question, the Bureau of Internal Revenue,[3] the Board of Tax

---

[1] *Webster's New International Dictionary* gives, among others the following definition: "Any thing, or those things collectively, in or to which a man has a right protected by law." "In a broad sense, any valuable right or interest considered primarily as a source or element of wealth."

"Property is a term of very broad signification, embracing everything that has exchangeable value or goes to make up a man's wealth, every interest or estate which the law regards of sufficient value for judicial recognition." *Samet v. Farmers & Merchants Natl. Bank of Baltimore* (C. C. A.), 247 Fed. 669, 671.

Chief Justice Marshall in *Soulard v. United States*, 4 Peters 511, said: "The term 'property' as applied to lands, comprehends every species of title inchoate or complete. It is supposed to embrace those rights which lie in contract—those which are executory as well as those which are executed." See also *Belk v. Henry Meager et al.*, 104 U. S. 279, *Sullivan v. Iron Silver Mining Company*, 143 U. S. 431.

[2] *Forbes v. Gracey*, 94 U. S. 762, 24 L. Ed. 313, 14; *Lynch v. Alworth-Stephens Company*, 267 U. S. 364.

[3] *I. T. 2524*, Cum. Bul. IX-1, page 199, where the conveyance of an undivided interest in all of the oil, gas and other minerals under described lands was classified as a sale of capital assets. See also *G. C. M. 2367*, Cum. Bul. VI-2, p. 172, where the sale by a taxpayer, in 1922, of the right to take gravel from land was classified as the sale of capital assets.

Appeals,[1] and the Courts,[2] treat the transfer of these rights by mineral deed or royalty sale as the sale of "property" constituting a capital asset.

Likewise, the term "sale" has a well defined meaning. This Court has said that a sale is "ordinarily, a transfer of property for a fixed price in money or its equivalent." *Five Per Cent Cases*, 110 U. S. 421. *Black* says that it is "a contract between two parties * * * by which the former, in consideration of the payment or promise of payment of a certain price in money, transfers to the latter the title and possession of an object of property." This Court has said again that "At all times, it means a contract between parties to give and to pass rights of property for money."[3]

---

[1]*Murphy*, 9 B. T. A. 610, acquiesced in by the Bureau of Internal Revenue, Cum. Bul. VII-2, p. 28, affirmed without opinion by the Court of Appeals of the District of Columbia, February 10, 1930. *Reynolds v. Commissioner*, 10 B. T. A. 651.

[2]Both the *Reynolds* and *Murphy* cases, cited in the preceding note, were affirmed without opinion on the authority of *Berg v. Commissioner*, 33 Fed. (2d) 641, by the Court of Appeals of the District of Columbia.

[3]*Williamson v. Berry*, 8 Howard 495, 544. See also definitions collected in *Ferguson v. Commissioner*, 45 Fed. (2d) 573, 4, 5.

There is nothing, either in the accepted definitions of "sale," or in the Taxing Acts, which require the seller to part "with his entire interest" in the subject matter of the sale in order to comply with the Statute (see p. 8, Petitioner's brief). Certainly the Statute applies as plainly and aptly to the sale of an undivided interest or a mineral interest as it does to the entire fee simple title to a property. Nor are we able to understand why the "spectre of the tax," referred to by the

Congress could have, by definition or limitation, enlarged or restricted this meaning in the Revenue Act, and this would have bound the Courts in construing it. But no other authority, State or Federal, could do so. In the absence of definition or restriction, it remains only to apply to the fact situation, the well understood meaning of the term. Certainly the Respondent does not contend that any different definition of "property" or "sale" by the Courts of Texas—assuming, as is not the case, that the terms are differently defined by Texas Courts—would limit to the slightest extent the right of the Federal executive and judicial authorities to place upon the terms, when contained in a Federal taxing act, their general, well understood, meaning.

But just as certainly as Federal authority is exclusive and paramount in that field, so is the authority of Texas to fix and determine, by legislative act and judicial pronouncement, the interest of a land owner in the minerals under his land and the effect of a written instrument relating thereto, paramount and exclusive. No Court[1] has

---

Petitioner (p. 17, Petitioner's brief) is not as much a deterrent to the owner of oil property as it is to the owner of any other kind of property. The deterrent was the high progressive surtax by which 50 per cent, or more, of receipts might be taken, and not the fact that the receipts might come from any particular source.

[1]For example, see *Hines Yellow Pines Trustees v. Martin*, 268 U. S. 458, 464, where this Court said: "But where the rule is one affecting title to real estate within the State, and has been repeatedly determined by decisions of state Courts, so it is established as the law of the state, there has been no departure from the rule that the Federal courts will follow the decisions of the state

more readily and frequently recognized this principle than has this. The general rulings are innumerable and to discuss them is surely unnecessary.

When we turn to the particular field of Federal taxation, and the effect to be given to State rules of property, when general language is used in a Federal taxing act, we find the same recognition of their effect that is here urged.

In the recent *Community Property Income Tax* cases,[1] this Court, in applying the law which taxed the net income *"of"* every individual, turned to the community property laws of Washington, Louisiana, Texas and Arizona, to determine whether the wife owned a portion of community income and, finding that she did, held that she, and not her husband, was to be taxed upon that part which State law said she owned. And shortly thereafter California, where the wife had theretofore been denied the right of reporting a share of the community income because she did not have under State law actual ownership,[2] presented for this Court's consideration the changes in the wife's rights brought about by State legislation, and this Court, finding that this legislation placed in her ownership of a share of community income, held that, after such change, she

---

courts (citing cases), and this is the rule even though the state rule is not approved." See also *DeVaughn v. Hutchinson*, 165 U. S. 566; *Warburton v. White*, 176 U. S. 484; *W. T. Waggoner Estate v. Wichita County*, 273 U. S. 113.

[1]*Poe v. Seaborn*, 282 U. S. 101; *Goodell v. Koch*, 282 U. S. 118; *Hopkins v. Bacon*, 282 U. S. 122; *Bender v. Pfaff*, 282 U. S. 127; *U. S. v. Malcolm*, 282 U. S. 792.

[2]*United States v. Robbins*, 269 U. S. 315.

was entitled to report that share for Federal Income Taxation.[1]

Certainly, nothing could more clearly demonstrate the proper spheres of State and Federal laws in cases of this character than these two California cases—where, because of a change in State law regarding property, an entirely different result in the application of the Federal Income Tax Law was required.

Most directly in point on the same question are two cases recenty decided by this Court, involving the taxability of the lessee's income derived from producing oil under leases made by a state agency. One of these, the *Group No. 1 Oil Corporation* case,[2] arose in Texas; the other, the *Coronado Oil & Gas Company* case,[3] arose in Oklahoma. The Texas case related to lands belonging to the University of Texas, a state agency and institution; the Oklahoma case involved lands belonging to the Common School System. In each case, it was contended that the lessee's income from producing oil under oil and gas leases on such lands was exempt because to tax such income was in effect to tax a state agency or instrumentality. The contention of the Texas lessee was denied because *"under the setted rules of the State with respect to oil and gas leases"*[4] these leases were *"present sales to*

---

[1] *United States v. Malcolm*, 282 U. S. 792.

[2] 283 U. S. 279.

[3] 284 U. S. 606.

[4] To support this statement this Court cited *Thieson v. Robinson*, 117 Tex. 489; *Texas Company v. Daugherty*, 107 Tex. 226; *Stephens County v. Oil & Gas Company*, 113 Tex. 160.

the lessees, upon the execution of the leases, of the oil and gas in place," the property thus becoming a "part of the common mass of property and subject to its burdens" so that the immunity from taxation which might otherwise apply to the instrumentality, selected by a State for the development of its public domain, could not be extended to cover property which, as was held to be the case, had *"passed to the buyer by a completely executed act of sale."*

But exemption from Federal Income Taxation was granted the Coronado Oil and Gas Company upon the income which it derived from operating an oil lease upon lands belonging to the Oklahoma Common School fund. Referring to the *Group No. 1* decision, the Court said:

> "And, as there distinctly indicated, the exemption claimed by the Oil Corporation was denied because under *the settled rule applied by the Texas Supreme Court the oil and gas from disposal of which the corporate income arose had been purchased,* not obtained under a lease—title had passed out of the State by a present sale. Status of the title was matter *for determination under laws of the State as construed and applied by her Courts.* In the present cause there is no basis for saying that, according to the local law, the transaction between the State and the lessee amounted to a sale. The distinction between cases involving sales and those where leases had been made seemed sufficiently apparent when *Group No. 1 Oil Corporation v. Bass* was decided and is not less obvious now."

In these cases, the *"status of the title"* as determined by State law was the determining factor in decid-

ing, in one case, that income from producing oil was exempt from and, in the other, that it was subject to, Federal Income Taxation.

Upon these authorities, we say that when the Supreme Court of Texas holds that oil and gas in place in Texas lands belong to the fee owner and that the effect of a certain instrument is to convey and sell that oil to the so-called lessee, those are facts to be accepted as such wherever the question of such ownership or the effect of such instrument arises. That another Court might not have so held as an original proposition, or might not have approved the reasoning which prompted the Texas Court's decision, is entirely beside the point.[1] The exclusive jurisdiction upon the question was in the Texas Court, and the owner of Texas lands has that estate in the minerals and other elements of value therein which that Court holds he has; and his written instrument with respect to such lands conveys exactly what that Court says it conveys. To those who say there is "no such animal," or that there shouldn't be; Kiplings words are a sufficient reply:

"Oh, what avails the classic phrase,
And what the cultured word,
'Gainst the untutored incident
Which actually occurred."

When we turn to Texas decisions to determine the holdings of its Courts upon these points, the answer is readily found. Perhaps it is necessary to refer to nothing

---

[1] *Hines Yellow Pines Trustees v. Martin*, 268 U. S. 458, 464.

else than this Court's statements of such holdings in the *Group No. 1* case, quoted upon page 18 hereof. But going to the decisions of that State, we find it consistently held that oil and gas in place are capable of ownership, that they belong to the owner of the fee,[1] that they are

---

[1]Perhaps the briefest summary of the Court's position upon these questions is contained in *Waggoner Estate v. Sigler Oil Company*, 118 Texas 509, in which the Court said: (p. 517) "The following propositions must be regarded as settled by repeated decisions of the Supreme Court: First: Such a writing as that here called a lease operated to invest the party called lessee and his assigns with title to oil and gas in place. *Texas Company v. Daugherty*, 107 Texas 226; *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Texas 160; *Humphreys-Mexia Company v. Gammon*, 113 Texas 255. Second: The estate acquired by the so-called lessee and his assigns was a determinable fee, which was lost on cessation of the use of the land for purposes of oil and gas exploration, development, and production. *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Texas 173; *Texas Company v. Davis*, 113 Texas 331; *Munsey v. Marnet Oil & Gas Company*, 113 Texas 220; *Robinson v. Jacobs*, 113 Texas 239; *Thomason v. Ham*, 113 Texas 246. Third: The estate of the lessee or of his assigns did not survive abandonment. *Grubb v. McAfee*, 109 Texas 530; *Munsey v. Marnet Oil & Gas Co.*, 113 Texas 219; *Thomason v. Ham*, 113 Texas 246. Fourth: Where a mining lease provided for oil or gas royalties and failed to define the lessee's duty as regards development after discovery of paying oil or gas, the law implied the obligation from the lessee to continue the development and production of oil or gas with reasonable diligence. *Benavides v. Huni*, 79 Texas 396; *Grubb v. McAfee*, 109 Texas 530, 531; *Texas Pac. Coal & Oil Co. v. Barker*, 117 Texas 418, 6 S. W. (2d) 1035, 1036; *Freeport Sulphur Company v. American Sulphur Royalty Company*, 117 Texas 439, 6 S. W. (2d) 1042, 1043. Fifth: Breach of the lessee's implied obligation for reasonable mineral operation will not authorize the forfeiture of the

capable of severance and sale, that the owner of the fee may divide his estate horizontally as well as vertically, that he may sell the surface and keep the minerals, or sell the minerals and keep the surface, or in short, carve out of his fee title such portion as he sees fit. And, from *Benavides v. Hunt*, 79 Tex. 396, decided in 1891, down to the present time, including the recent cases of *Theisen v. Robinson*, 117 Tex. 489, *Waggoner v. Sigler*, 118 Tex. 509, and *Ehlinger, County Judge v. Clark*, 117 Tex. 547, it has been consistently held that the effect of those instruments ordinarily called oil and gas leases is to convey to the lessee title to the oil and gas in place—to make him the owner and his title a determinable fee. The Texas Supreme Court has expressly given all such instruments that effect although one may "bargain, grant, sell and convey" the oil and gas, which another might "let, lease and demise," the property for the purpose of exploring for, developing and removing the oil and gas. That Court has expressly said that there was no basis for distinguishing between the effect of such instruments because of the language used, that the rights granted

---

lease as for breach of condition subsequent, such obligation being a covenant. *Grubb v. McAfee*, 109 Texas 530; *Texas Company v. Davis*, 113 Texas 335. Sixth: The usual remedy for breach of the lessee's implied covenant for reasonable development of oil and gas is an action for damages, though under extraordinary circumstances—where there can be no other adequate relief—a court of equity will entertain an action to cancel the lease in whole or in part. *Texas Pac. Coal & Oil Company v. Barker*, 117 Texas 418, 6 S. W. (2d) 1035; *Freeport Sulphur Company v. American Sulphur Royalty Company*, 117 Texas 439, 6 S. W. (2d) 1045; *Grubb v. McAfee*, 109 Texas 534, 535."

were the same, and that it had consistently so held since *Benavides v. Hunt.*[1]

---

[1]In *Stephens County v. Oil & Gas Company*, 113 Tex. 160, the Court said, at p. 172: "We find it impossible to reasonably ascribe to the two sets of instruments, disregarding mere form and looking at substance, any different legal effects as regards the transfer of title to the oil and gas in place. Notwithstanding the distinctions attempted to be drawn in the decisions, we cannot conclude otherwise than that there is no real difference in the title conveyed, whether an instrument takes the form of a grant of the exclusive right to mine and appropriate all of a certain mineral—as in *Benavides v. Hunt*, supra—or takes the form of a demise of the land, for the sole purpose of mining operations coupled with a grant of the exclusive right to produce and dispose of the mineral—as in this case—or takes the form of a grant of the mineral with the exclusive right to mine for, produce, and dispose thereof—as in *Texas Company v. Daugherty*, supra. The results are substantially the same to all parties at interest, whether the one or other form of instrument be used. Why hold that instruments in different forms create different estates, where there is no difference in fact with respect to that of which each divests the grantor, his heirs or assigns, nor with respect to that with which each invests the grantee, his heirs or assigns?"

It should also be noted that the same holding is reached whether the royalties are payable in money, as they were in the *Theison case*, or at the option of the lessee in money or oil, as in the *Stephens* case, or in oil, as they were in the *Ehlinger* case, and as they are in this case. Upon this point, the Court said in the *Ehlinger* case, (p. 558): "We think the purchase price is the $4,000.00 evidenced by the notes specified in the contract and one-eighth of the oil, not as it existed in place, but after, by the expensive process of exploration, drilling, and production, the oil has been captured and reduced to possession, produced at the surface of the earth, and delivered at the intake of the pipe line as personalty. * * * (p. 563) We are unable to find any practical difference

The Courts of Texas give substance to these holdings. It is not simply a question of creating a particular estate by calling it by that name. It is there held that the lessee's estate is subject to ad valorem taxation as real estate, in the County where the land is situated.[1] The formalities required to convey by deed are required to make an oil lease;[2] If the land covered is a homestead, the wife must join and privily acknowledge the instrument in the same way as if the entire homestead were being sold.[3] The Statute of Frauds applies to all contracts relating thereto.[4] The lessee has the right of exclusive possession to the extent necessary to enjoy his estate. All necessary easements, if not expressly granted, are implied.[5] The interests of the lessee can be mortgaged, a vendor's lien is frequently retained against it

---

between the payment made in money, in amount equal to one-eighth of the oil produced, and the actual payment in oil, a commodity which we know is readily convertible into cash. If the one is a diversion of the school fund, the other is necessarily such a diversion—but, neither is a diversion. The contract before us is simply the usual one made generally over the country by those who sell mineral rights, and well within the constitutional powers of the Commissioner's Court to make."

The lease involved in the *Ehlinger* case is set out in full in the Court's opinion, pp. 550 to 552, and it will be found to be practically identical with those involved in this case.

[1]*Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Tex. 160; *Waggoner Estate v. Wichita County*, 273 U. S. 113.

[2]*Hager v. Stakes*, 116 Tex. 453.

[3]*Southern Oil Company v. Colquitt*, 69 S. W. 169.

[4]*Green v. Priddy*, 112 Tex. 567.

[5]*Campbell v. Schrock*, 10 S. W. (2d) 165.

when created or transferred, mechanics and materialmen may acquire the usual liens thereon.[1] Only under most unusual circumstances is it subject to cancellation,[2] and it can endure until every element which gives it value is exhausted—that is, until the thing actually sold, the mineral content, is entirely removed and appropriated.

Oil and gas leases and assignments thereof come within the purview of registration statutes.[3] The Statute which specifies those covenants which are implied in "conveyances" apply to such instruments.[4] The Statute which denies a tenant the right to sublet without the written consent of his landlord is not applicable to an oil and gas lease.[5]

In applying the statutes which define and limit the separate and community estate of a husband and wife, oil and gas leases are treated, as are all other conveyances of real estate, and the proceeds derived are classified as separate or community in the same way that they would be classified were these proceeds derived from the sale of the entire fee simple title to the property.[6]

In his brief the Petitioner takes the position that *Stephens County v. Oil & Gas Company*, 113 Texas 160, decided in 1923, changed the rule in Texas as to the nature of an oil and gas lease and the estate conveyed thereby.

---

[1]Articles 5473-5479, Revised Statutes of Texas, 1925.
[2]*W. T. Waggoner Estate v. Sigler*, 118 Tex. 509.
[3]*English v. Plumlee*, 291 S. W. 922.
[4]*White v. Murphy*, 229 S. W. 641.
[5]*Gladys Belle Oil Company v. Turner*, 12 S. W. (2d) 847.
[6]*Stephens v. Stephens*, 292 S. W. 290; *Ferguson v. Commissioner*, 45 Fed. (2d) 573.

This is stated on page 15 of Petitioner's brief. We submit that this statement is entirely incorrect, and that this Court, both in *Group No. 1* and the *Coronado Oil & Gas Company* cases, recognized that the rule in Texas had been long continued, that it was a rule of property, that it was the "settled rule." Certainly the Supreme Court of Texas has announced so frequently that this was its consistent holding, from *Benavides v. Hunt*, decided in 1891, to *Waggoner v. Sigler*, 118 Texas 509, that he who makes an assertion to the contrary is bold indeed. We are sure that this Court is not interested in the interpretation which the intermediate appellate courts of Texas may have placed upon such instruments, and upon the decisions of the Supreme Court from time to time, since the Supreme Court has spoken so emphatically upon the subject. To refute Petitioner's assertion upon this point, we are content to ask the Court merely to examine *Benavides v. Hunt*, 79 Texas 396, *Southern Oil Company v. Colquitt*, 69 S. W. 169 (writ of error denied), *Texas Company v. Daugherty*, 107 Texas 226, *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Texas 160, *Theisen v. Robinson*, 117 Texas 489, *W. T. Waggoner Estate v. Sigler Oil Company*, 118 Texas 509.

We likewise submit that, entirely apart from the rules of Texas upon the subject of oil and gas leases, it must be held that such instruments constitute sales of capital assets under Section 208. If oil and gas in place is not considered capable of ownership, it is nevertheless, everywhere held that a land owner's rights thereto consti-

tute valuable property rights.[1] This Court has held, quite recently, that such rights are property.[2] This undoubted right to explore for, reduce to possession, and dispose of, is everywhere a valuable property right, the subject of barter and sale, and the basis of enormous financial transactions, having every element of property, as the term is ordinarily used. Every Court protects it as property. Everywhere, instruments such as those involved in the case at bar, are held to transfer and convey valuable property rights. Nothing more is needed to make such transactions sales of capital assets.[3] "Property" as used in Section 208, is not confined to real estate or chattels. Obviously, it applies to stocks, bonds, other choses in action, to patents, to copyrights [4]and similar intangibles.

Nor is the fact that the rights granted are sometimes subject to cancellation of moment. That was an incident

---

[1]*Forbes v. Gracey*, 94 U. S. 462.

[2]*Lynch v. Alworth-Stephens Co.*, 267 U. S. 364.

[3]Against this it may be argued that since oil and gas in place is not subject to ownership, in such jurisdictions the period of time between oil and gas being reduced to possession and the sale is not sufficient to bring the time of actual ownership within the statutory limitation of two years. Cf. *Alexander v. King*, 46 Fed. (2d) 235. But this theory can have no application here. If we discard the theory of ownership of oil and gas in place, then the thing actually sold by the instruments in question is the right to explore and reduce to possession, which has co-existed with the fee title since its original acquisition.

[4]In *I. T. 2169*, Cum. Bull. IV-1, page 13, the sale, in 1924, of the motion picture rights to a play written and copyrighted in 1921 was held to be a sale of capital assets under the 1924 law. In *A. W. Henn v. Commissioner*, 20 B. T. A. 1133, real estate leases in the hands of the lessee were stipulated to be capital assets (p. 1151).

of all estates at early common law.[1] Such instrumentalities have from time immemorial been used to develop minerals of all kinds, and for that long have been recognized as valuable, defeasible, vested property rights, the subject of barter, sale, inheritance and taxation, granting the exclusive right to use, possess and consume at least a portion of the minerals.[2] This Court will not read limitations into

---

[1]*Castillero v. U. S.*, 2 Black 169, 17 L. Ed. 380.

[2]In the *Theisen* case the Supreme Court said (page 504): "Mr. Lindley traces far beyond the dawn of our present civilization the custom of sales for royalties of minerals, such as tin, iron, and coal, apart from the balance of a tract of land containing same, and points out that the vendee of the minerals acquired an estate in the land subject to the payment of debts. Discussing the oldest mines in England, once worked by the Romans, Mr. Lindley says: 'The right of working the tin mines of Cornwall was conferred upon all free tinners upon the render of a certain portion of the minerals raised to the owner or lord of the soil. This portion was called dish or toll tin, and was usually one-fifteenth of the production. Any tinner was allowed to 'bound' any unappropriated waste lands or enclosed lands which had formerly been waste subject to this custom. He 'bounded' the same by the delivery of toll tin to the lord of the soil. * * * * The bounds might be sold or demised, and were frequently farmed out for a render called farm tin, and were liable for the payment of debts and legacies. The estate was in the nature of a chattel real, and passed to the executor.' *Lindley on Mines* (2d Ed.) sec. 5, pages 9 and 10. After tracing the custom to realize on minerals by means of separate sales thereof for royalty from ancient England to the American States, Mr. Lindley states: 'Under the English law, rights of property in the surface and in the underlying mines might be shown to be in different owners. Nothing was more common than to sell or demise a piece of land excepting the mines. In like manner the different strata of the subsoil might be shown to be the subject of different rights. And

this taxing statute where none exist; but will determine that the rights transferred by these instruments were valuable property rights owned by Harmel for more than two years, and that, when he transferred them for a substantial consideration in cash, he made a sale within the ordinary meaning of that term.

These conclusions are supported in many other ways. The capital gain method of taxing profits was first introduced in the 1921 Act. It was brought into being by the obvious injustice of taxing at progressive rates in one year gains which, though realized in that year, were really the fruit of a longer investment. Certainly Congress had transactions like these in mind when the Committee on Ways and Means said in recommending and reporting the Section (H. R. 350, 67th Cong. 1st Sess. pp. 10-11):

Capital Gain and Capital Loss

"Section 206: The sale of farms, *mineral properties*, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is

---

there might be also in one mine different minerals which were the property of different persons. Thus, one person might be entitled to the iron, and another to the limestone. When the surface and underlying mines or the different strata of the subsoil were differently owned, they were separate tenements, with all the incidents of separate ownership—a distinct possession and distinct inheritance; and the mines of each stratum might be held in fee simple, or fee tail, or otherwise, as in the case of surface property.' *Lindley on Mines* (2d Ed.), sec. 9, pages 14 and 15."

realized. Many such sales, with their possible profit taking and consequent increases of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

The report of the Senate Committee on Finance was in substance the same. Senate Report No. 275, 67th Cong., 1st Sess., pp. 12-13.

The language of Section 206 of the 1921 Law is, in all pertinent respects, identical with Section 208 of the 1924 Law and the corresponding sections of later laws.

Important, too, is the fact that a lessee is allowed and required to treat the bonus paid the land owner as the cost of his interest in the minerals.[1] This cost is the primary basis of his depletion allowance and, in case of a subsequent sale or disposition of the interest acquired, the basis for determining the gain or loss resulting therefrom. Certainly that which is "cost" to lessee is "selling price" to the

[1]Regulations 65, Article 203.

lessor to whom it is paid and is for the interest, the cost of which is so fixed, acquired.

The lessor, in turn, was required to use an aliquot portion of the sum so received to absorb his cost or basis and depletion on later royalty payments was allowed only to the extent of the reduced basis. The method was changed by T. D. 3938, but the princple remains the same.[1]

The rules here urged have been applied by the Treasury Department for many years in situations which cannot be distinguished from that presented by the case at bar. From the Revenue Act of 1918, through the Revenue Act of 1924,[2] (the Act here under consideration) and again by the recent Act of 1932,[3] a stamp tax was imposed upon any "deed, instrument, or writing whereby any lands, tenements or other realty *sold* shall be granted, assigned, transferred or otherwise conveyed to, or vested in, the purchaser or purchasers, etc." It should be borne in mind

---

[1]Regulations 65, Article 216. These, with other pertinent Regulations are set out in the Appendix, see page 72 hereof.

This, in recent years, has been largely theoretical, as the Bureau of Internal Revenue has been allowing no depletion or other deduction since *Murphy Oil Company*, 15 B. T. A. 1195. None was allowed in this case, nor was any allowed in the *Ferguson* case, 45 Fed. (2d) 573. No case, it is believed, can be cited which shows that any depletion deduction has been allowed a lessor on the consideration or "bonus" received for a lease.

[2]Title IX, Sec. 1100 and Schedule A (7) Revenue Act 1918. Title XI, Sec 1100 and Schedule A (6), Revenue Act of 1921. Title VII, Section 800 and Schedule A (5), Revenue Act of 1924.

[3]Section 725, Revenue Act of 1932.

that this language was in the very act here under consideration, that it had been in the two previous acts, and was again incorporated into the 1932 Act. Here, again, the basis is the act of selling; only those instruments conveying realty, etc., "*sold*" were to be stamped. But the Bureau of Internal Revenue, beginning with Regulations promulgated for the enforcement of the 1918 Act, consistently held that State law was determinative of what was realty and whether a sale had been made.[1] In entire consistency with this, it held that, in those states where oil leases were considered sales of realty, stamps must be affixed to leases and assignments thereof,[2] while in those states where different rules prevailed, stamps were not required.[3] Thus leases and assignments of leases on Texas lands were stamped from 1918 until 1926, (the entire Stamp Tax on conveyances was omitted from the 1926 Act) while instruments of identical verbiage on lands in Oklahoma and Louisiana went untaxed.

Since the passage of the 1932 Act, Regulations of the same purport, making state rules of property the deciding factor, have been promulgated[4] and an express ruling holding that an oil and gas lease on Texas land, similar to

---

[1]These Regulations, including those adopted under the 1932 Act, are set out in the Appendix, pp. 75-78.

[2]*S. M. 4439*, Cum. Bul. IV-2, page 52. "Under the laws of Texas the interest conveyed under the oil lease constitutes an interest in real property and the instrument is subject to the Federal Stamp Tax imposed by Schedule (a) (5) Title VIII of the Revenue Act of 1924." See also ruling under 1932 Act set out in the appendix.

[3]For example, *G. C. M. 913*, Cum. Bul. V-2, page 255, dealing with Louisiana.

[4]Appendix pp. 72-78.

those in this record, must be stamped because it conveys an interest in realty, has been issued.[1]

We can only leave it for Petitioner's counsel to explain why a transaction, which, under one section of the law, constitutes a sale of realty, does not, under another section of the same law, constitute a sale of "property."[2]

We have heretofore referred at sufficient length to the principles decided by the *Community Property Tax* cases, by the *Group No. 1* and the *Coronado* cases. Another example of State law and its relation to Federal taxation is *Crooks v. Harrelson*, 282 U. S. 55, where the State law regulating the property of a decedent subject to the payment of debts and expenses of administration was given effect in determining the net estate of a decedent subject to a Federal Estate tax. *U. S. v. Cambridge Loan & Building Company*, 278 U. S. 55, applies the same principle.

The conclusion is unescapable that, since Congress did not limit the general terms which it used in Section 208, but made a taxpayer's rights thereunder depend upon whether property was sold, we must look to State rules of property—in this case—Texas—to determine whether the taxpayer owned property and whether that property was

---

[1]See Appendix page 76.

[2]In his brief the Petitioner says (page 32): "Putting the Texas decisions aside, it is still true that even though oil and gas lease does not amount to a conveyance of the oil and gas in the ground, it does amount to a conveyance of an interest in the land. *Ewert v. Robinson*, 289 Fed. 740, 750, (C. C. A. 8th)." What more is necessary, we submit, to make it a conveyance of property?

conveyed. When this test is applied, by the ruling of this Court, and the Supreme Court of Texas, only one answer can be made. *Property was sold.*

II.

We submit that it is entirely unnecessary to speculate as to the sense in which Congress used the word "sale" in the Capital Gain Section of the law; and that it cannot be argued that Congress intended to include some sales and exclude others. (See Petitioner's brief, pp. 15-19). The word is used without qualifying language and no rule of construction warrants qualification by implication, particularly in a taxing statute. We cannot indulge the presumption that Congress did not realize that, when not qualified "at all times, it (sale) means a contract between parties to give and to pass rights of property for money." *Williamson v. Berry*, 8 How. 495, 544.

But, if we were to seek a determination of the sense in which Congress used the term, the necessary conclusion is directly opposite to that reached by Petitioner in his brief. In another title of the law, the word "sold" is used under circumstances which require its application to oil and gas leases; and in the same title, there are provisions regarding the depletion allowance applicable to oil properties which make it necessary to fix the treatment of the bonus paid for an oil lease. By examining these, we can throw some light upon the question of whether Congress understood and intended that "sale" should include the making of an oil lease. This will be all the more helpful because the same language was in both the 1918 and

1921 laws, and had received the same construction since the 1918 Act was adopted.

We have already seen that, by Schedule A (7) Sec. 1100, Title IX of the 1918 Act, stamps were required upon a "writing whereby any lands, tenements or other realty *sold* shall be granted * * * * to the purchaser * * * * or purchasers"; that the same language was used in the 1921 and 1924 Acts; and, after being omitted from the 1926 and 1928 Acts, were reincorporated in the 1932 Law (31-34 hereof). Likewise, we have seen that this has been consistently applied from 1918 to date to include oil leases in Texas, on account of the very rule of State law upon which we rely here; and to exclude oil leases in those states where no interest in real estate was conveyed. This construction of the word "sold" in the 1918 Law has received Congressional sanction by three separate re-enactments, one in the very law with which we are here concerned.

If we must seek Congressional intention, how can we say that by using the word "sale" without limitation in the 1921 and 1924 Capital Gain Section, Congress did not intend it to have the same meaning as "sold" used in the same laws, and that this meaning was not the same as that which it was approving at that very time by re-adopting the stamp tax title of the law?

The depletion section of the law strongly supports this. Again we have the same language used in the 1918, 1921, and 1924 Acts and construed in the same way under all three Acts. In the 1918 Law (Sec. 214 (a) (10)) it is provided that, in computing net income, there shall be allowed as a deduction:

> "In the case of mines, oil and gas wells * * * * * a reasonable allowance for depletion and for depreciation of improvements * * * * * based upon *cost* including cost of development not otherwise deducted * * * * *. Provided further, that in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of *purchase* of a proven tract or *lease*, where the fair market value is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value, etc. * * * * * In the case of leases, the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

The last sentence shows Congress had lessees in mind. In fact, many of the allowances provided for the subdivision were denied lessors until authorized by an opinion of the Attorney General.

The first provision is that the allowance should be based "upon cost including cost of development not otherwise deducted." Other than development costs, what other "cost" could there be except the bonus—paid the lessor in all of those cases where the lease was acquired directly from the land owner? If the "bonus" is "cost" to lessee, can it be anything but "selling price" to lessor? Is the word apt to describe rentals, license fees, or payments of that sort?

"Cost" is used again in the "discovery" portion of the subdivision, and in connection with the phrase "*purchase* of a proven tract or *lease*." We submit that these excerpts show plainly that Congress regarded transactions like those here involved as sales between the lessor and lessee; "cost," "purchase," "acquisition" can have no other mean-

ing. They furnish unmistakable criteria to determine how Congress intended that the word sale, in the same law, should be construed, and applied.

This view is emphasized by the treatment of these statutory provisions in Regulations 45, adopted for the enforcement of the 1918 Law. It is there stated:

> "Art. 201: * * * * The essence of these provisions of the Statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions. * * * * * The term 'basic date' indicates the date of valuation, i. e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery or within thirty days thereafter in the case of discovery. * * * * *"

> "Art. 203. Capital recoverable through depletion deductions in the case of a lessee—(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions. * * * * * (d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost. (e) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within thirty days thereafter, of his equity in the mineral discovered."

"Art. 205. In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral right or leasehold was acquired, the owner or lessee will be required to show that the cost or price at which the property was bought was fixed for the purpose of a bona fide purchase and sale, by which the property passed to an owner in fact as well as in form other than the vendor."

The original treatment of a bonus required of a lessor is provided in Article 215, where it is said:

"(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of the lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining, the difference may be recovered through depletion based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

Without further extending these quotations, we affirm that the Regulations regarding depletion, from Article 201, p. 76, through Article 237, p. 100, cannot be read without the reader being forced to the conclusion that at all times the Treasury Department has treated the bonus paid by a lessee to a lessor as the lessee's cost and as the selling price of the lessor, and the transaction

as transferring the interest, specified in the instrument, in the mineral content, from the lessor to the lessee; and as creating, to the extent of the bonus, a capital investment upon the part of the lessee and as reducing the capital investment of the lessor.

When it is remembered that substantially the same Regulations were passed for the enforcement of the later Acts, which contain the same language in the depletion section, and when thereby this treatment was given repeated Congressional approval, it is again conclusively demonstrated that Congress understood and approved of the treatment of oil and gas leases as sales.

We know of no other sections in the law which will throw any light upon Congressional intention, and, if it is proper to attempt by such standards to construe the word "sale," when it is used without qualification, we submit that from no source, from which Congressional intention can be gathered, can any inferences be drawn which will exclude from that word's meaning, transactions like those before the Court here.

III.

Thus far, we have attempted, in the main, to deal affirmatively with the question presented. We will now endeavor to take up the authorities and reasoning urged to support the contrary view.

We submit that the Petitioner's entire argument is predicated upon a false premise, which is clearly disclosed in the statement of the question presented. He there says that the question is whether or not cash bonuses

"paid as advanced royalties" constitute income from the sale of capital assets, etc. We submit that the so-called bonus was not paid as an advanced royalty. It was the consideration for the estate granted. The instruments themselves make this entirely clear. The provisions contained in such instruments, regarding royalties, are entirely separate and distinct from, and independent of, the provisions stating the consideration for the grant. The whole theory of Texas law relative to oil and gas leases refutes any such contention. Without the cash consideration, most oil and gas leases in Texas would be unilateral and of no force and effect, and the Courts of Texas have been frequently called upon to determine whether or not the consideration paid in cash, upon the execution of such instruments, was adequate and sufficient to support the grant. A discussion of this, with numerous cases showing its application, will be found in Thuss on Texas Oil & Gas, Section 46, p. 68.

Probably the first Court decision upholding the Petitioner's view is the case of *Hirschi v. U. S.*, 67 Ct. Cls. 637, decided May 6, 1929, in which this Court denied certiorari, 280 U. S. 576.. In no material respect does that case differ from the one at bar. The 1921 Act was involved, rather than the 1924, but the applicable provisions of both Acts are the same. The property involved was situated in Texas.

The Court of Claims first said that since *Stratton's Independence v. Howbert*, 231 U. S. 399, "the proceeds received from such leases of oil and mineral lands were to be treated as gross income"; that the Board of Tax Appeals had consistently held "tnat sums received as

bonus or royalties from such leases of oil and mineral rights were not income from the sale or exchange of capital assets but gross income. We hold it to be gross income."

As to the Texas rules regarding oil leases, it was said that such rules were against the weight of authority, and the decisions of this Court. The opinion continued:

> "To say that the holding of the Supreme Court of Texas upon the application of this principle to a given state of facts is sufficient to control the United States Courts in the construction of the United States Revenue Act in the face of the contrary application of the principle by the United States Courts is too untenable to require discussion."

Then, after saying that state rules of property governed in certain matters, the Court said that "the State decisions cannot control on a question of general jurisprudence as in this case."

The Court cited its own decision in *Steedman v. U. S.*, 63 Ct. Cls. 226, in which, in applying the Federal Estate Tax, it refused to give effect to the laws of Missouri regarding the sale of a decedent's real estate for the payment of debts; cited *Burk-Waggoner v. Hopkins*, 269 U. S. 110, and closed by referring to the fact that the Federal Government, in its selection of subjects for taxation, was not limited by the construction placed by State Courts upon property rights, that it was—

> "Not called upon to suit the revenue system of the country to the varying and conflicting decisions and laws of the different states,"

That—

> "Where the constitutional powers of the Federal Government and the States conflict, those of the States must give way."

These excerpts show the ratio of the *Hirschi* decision and, at the same time, cover the major points of later decisions and the arguments most frequently urged against Respondent's position. Perhaps the only authority in point cited by the Court of Claims is that Court's decision in *Steedman v. U. S.*, 63 Ct. Cls. 226 (in which this Court denied certiorari). As to this, it is sufficient to say that the identical question later reached this Court in *Crooks v. Harrellson*, 282 U. S. 55, and this Court there reached exactly the opposite conclusion and did exclude certain real estate from the gross estate of a decedent subject to Federal Estate Tax because the law of Missouri did not make such real estate subject to the payment of debts and the expenses of administration; although in other states, where the State law is different, real estate is taxed.[1] Petitioner cannot comfort from that portion of the *Hirschi* decision.

Nor is the decision of this Court in *Burk-Waggoner v. Hopkins*, supra, cited by the Court of Claims, applicable. No question is involved here of the power of

---

[1]Cf. *First Trust Company of Omaha v. Allen* (District Court of Nebraska), 51 Fed. (2d) 1069, where, because of the difference in State Law; Missouri lands were not included as subject to the Federal Estate Tax, while land belonging to the same estate in Nebraska and Iowa were included. Affirmed by the 8th C. C. A., 51 Fed. (2d) 1069.

Congress in selecting subjects for taxation. We have never thought of contending that Section 208 could not have been framed so as to exclude transactions like those here involved, regardless of State law, and at the same time include other transactions. By the same authority which enabled Congress to define a capital asset as property held for two years, and to exclude stock in trade or property ordinarily included in inventory from the benefits of the capital gain section;[1] the line could have been drawn to exclude the income derived from making an oil and gas lease. But that is a question of power, with which we are not here involved; ours is the easier task of determining what Congress has done, rather than what it can do. The *Burk-Waggoner* case, on the other hand, was directly concerned with whether Congress could segregate joint-stock associations—classified as partnerships under State law—from ordinary partnerships, and tax the income of one differently from that of the other without violating constitutional restrictions. That this Court held that this could be done, in no way aids in the determination of what Congress did do in Section 208 of the 1924 Act.

Again, based upon *Stratton's Independence* and related cases, the Court of Claims held in the *Hirschi* case that sums received "as a bonus * * * from such oil or mineral leases were not income from the sale or exchange of capital assets, but gross income." The first criticism of this is the apparent holding that "income from the sale or exchange of capital assets" is not "gross income," and the attempt to place those situated as Respondent is

---

[1]Section 208 (a) (8), Revenue Act of 1924.

in the attitude of contending that such income is not subject to taxation. Of course, no such contention is made. The sum in question must be "income" and taxable under the general definition of income in the statute[1] before the question of whether or not it is a capital gain can arise. The items in question are "gross income" because there is, under the facts of this case, nothing of cost to deduct from the selling price. We have always admitted that the $57,000.00 in question was "gross income"; it also happens that the entire sum is "net income." We say that, in all cases, the gain from the sale or exchange of capital assets is gross income. Any contrary view, no doubt arising from *Gray v. Darlington*, 15 Wallace 63, and the conception of income under English Income Tax laws,[2] if not set at rest by the very terms of the 16th Amendment and this Court's decisions under the 1913 Act,[3] was certainly disposed of by *Merchants Loan & Tr. Co. v. Smietanka*, 255 U. S. 509, decided by this Court in 1921.[4] In truth, the determination that the sum in question is gross income, invokes, rather than answers, the question here. Is it that character of gross income which under Section 208, is derived from the sale or exchange of a capital asset?

---

[1]Section 213, Revenue Act of 1924.

[2]*Merchants Loan & Trust Company v. Smietanka*, 255 U. S. 509, 521, 522.

[3]*Brushaber v. Union Pac. Ry. Co.*, 240 U. S. 1; *Stanton v. Baltic Mining Company*, 240 U. S. 103; *Southern Pacific v. Lowe*, 247 U. S. 330; *Lynch v. Turrish*, 247 U. S. 22.

[4]See also *Eldorado Coal & Mining Company v. Magar*, 255 U. S. 522; *Goodrich v. Edwards*, 255 U. S. 527; *Walsh v. Brewster*, 255 U. S. 536.

The authorities heretofore discussed (pp. 17-20 hereof) would seem to be a sufficient answer to the pronouncements of the Court of Claims that the State laws cannot control the selection of objects of Federal taxation. In addition thereto, we do not contend, and we have never contended that State legislation or decisions can control the Federal taxing power, or the selection by Congress of objects of taxation. Certainly this Court has announced too plainly and frequently that the taxing power granted to the general government was limited only by the terms of the Constitution itself, for any one to question it now, and we disclaim any intention of so doing. But just as plainly, has the power and intention of Congress to relate the exercise of the taxing power and the subjects taxed to state property rules been upheld by this Court, where the language used by Congress, fairly construed, expressed that meaning. That, we contend, has been done here.

There are many examples of this. The *Community Property* cases, heretofore discussed (p.17) are directly in point. The basis of the whole income tax, as it related to individuals, was involved. The thing taxed was the "net income of every individual." The basic question was where to look to determine what made income that "of" a particular individual. Just as we assert should be done in this case, the Court there put the ordinary, general meaning of the word "*of*" as denoting ownership, and continued:

> "The Commissioner concedes that the answer to the question involved in the cause must be found in the provisions of the laws of the State, as to a wife's

ownership of, or interest in community property. What, then, is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor? *Poe v. Seaborn*, 282 U. S. 101.

This concession is a concession of the very principle for which we contend here.[1] When the general question of ownership is involved in relation to Federal tax matters, and Congress has not, by definition or limitation fixed the standard to be applied, State law is the only standard that can be applied. So here, the basic questions are what interest did Harmel have in the oil and gas prior to the execution of the leases, and what interest was conveyed by the leases? Does the interest, originally owned by Harmel constitute "Property"? Did property pass for a consideration by virtue of the execution and delivery of the instruments? Here again, as in the Community Property cases, the Commissioner should concede that the answer is to be found in State law.[2]

---

[1]It is difficult to understand how ownership can be determined by one standard and a transfer of ownership by another, when the latter is nothing but an inquiry into the ownership before and after a given transaction.

[2]It is entirely clear that we are not seeking an exemption from taxation, but rather to determine under which one of two classifications—the one advantageous, the other burdensome—it is proper to place Harmel's income. Since this Court has repeatedly extended the rule of strict construction of taxing statutes, even to limitation in favor of the taxpayer *(U. S. v. Michel*, 282 U. S. 656, *U. S. v. Updike*, 281 U. S. 489), we see no reason whatsoever why the law should not be construed strictly in favor of the taxpayer, as in the ordinary case, rather than strictly against him, as suggested by Petitioner (p. 19, Petitioner's brief).

Crooks v. Harrellson, 282 U. S. 55, heretofore referred to, is another application of the general principle. There, because the Revenue Act related the property of a decedent to be included in his gross estate, to the property subject to the payment of debts and the expenses of administration, State rules upon the latter question were given effect, and real estate excluded. This was done although, in many other, and, perhaps, the majority of states, property of the same character would have been taxed.[1] And it is important to note, in illustration of the rule, that later Federal Estate Tax laws, by changing the definition of property to be included in the gross estate, avoided the application of this State rule,[2] just as California met the test of the unchanged phrase—"net income of every individual"—by changing her community property laws to confer ownership of a share of the community property upon the wife.[3]

---

[1]*First Trust Company of Omaha v. Allen*, 52 Fed. 1069.

[2]The 1918 Act was involved in the *Harrelson* case. There it was provided in Section 402 "That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—(a) to the extent of the interest therein of the decedent at the time of his death, which, after his death, is subject to the payment of the charges against his estate and the expenses of its administration, and is subject to distribution as part of his estate." The same language was used in Section 402 of the 1921 Act and Section 302 of the 1924 Act, but in the 1926 Law (Section 302 (a)) this was changed to read simply "To the extent of the interest therein of the decedent at the time of his death."

[3]*U. S. v. Robbins*, 269 U. S. 15; *U. S. v. Malcolm*, 282 U. S. 792.

The *Cambridge Loan and Building* case[1] applied the same principle. There those associations regarded by State law as mutual Building and Loan Associations were exempted from Federal Income taxation under a clause which exempted "Domestic building and loan associations and co-operative banks organized and operated for mutual purposes and without profit."[2]

As heretofore pointed out, the Petitioner is today applying it with respect to stamp taxes on oil and gas leases, and assignments thereof, and, in effect, saying in one breath that we must look to the State law to determine whether *realty* is *sold*, and in the next, that we cannot, under the Capital Gain Section of the same Act, look to that law to determine when property is sold or exchanged.[3]

Weiss v. Weiner, 279 U. S. 333, has been sometimes cited as opposed to this rule. But an examination of it, particularly in the light of the decisions below, 17 Fed. (2d) 650 and 27 Fed. (2d) 200, will show that it does not conflict with and, perhaps, supports our view. Weiner dealt in 99-year leases on Ohio property. He acquired several without cost, all being acquired subsequent to March 1, 1913. He was obligated to pay rental, to maintain and, in some cases, to improve. He had in each case an option to surrender and be released of further obligation. He sublet the premises so leased. At the time of the trial, about half of the leases had been surrendered or had been assigned in such a way as to relieve him of

---

[1]278 U. S. 55.
[2]Sec. 231 (4), Revenue Act of 1918.
[3]See pp. 31-33 hereof and Appendix pp. 75-78.

further responsibility. In the tax years in question, he was allowed to deduct all expenditures for repairs and depreciation upon the cost of all improvements placed upon the properties by him. He sought, in addition, a depreciation deduction based upon the value at the time his leases were obtained of the improvements upon the leased properties. This was denied. It is clear from a reading of all of the opinions in the case that this was denied because the familiar statutory provision for the allowance of depreciation (formulated in the 1909 Excise Tax Law and unchanged since), had always been construed as a provision to restore through annual allowances the gradual loss of capital invested in (or the March 1, 1913, value of) depreciable assets,[1] and where, as there, no capital investment had been made, there was nothing to depreciate. Weiner was not allowed to anticipate and accumulate tax free a reserve against a contingent liability to invest, improve or restore, particularly where experience had demonstrated that it was improbable that he would ever be called upon to invest the reserve in that way. In concluding the opinion in the case, this Court said, through Mr. Justice Holmes:

> "It does not matter that in Ohio, where the properties lie, these long leases are treated as in many respects like conveyances of the fee. The Act of Congress has its own criteria, irrespective of local law, that look to certain rather severe tests of liability and exemption and that do not allow the deductions demanded whatever the lessees may be called. We understand this to be the view taken by the De-

[1] *Ludey v. U. S.*, 274 U. S. 295; *Thompson Oil & Gas Company v. U. S.*, 283 U. S. 301.

partment for a long time and we are of the opinion that it should not be disturbed."[1]

Under the circumstances of that case, it would not have mattered if the instruments had, in fact, been conveyances of the fee, rather than in many respects, like such conveyances. The basic question, under the test laid down by Congress, was whether the taxpayer had a capital investment in the property. Since he had not, there was from his standpoint nothing to depreciate, and it truly mattered not what construction the laws of Ohio placed upon the instrument, since no construction could take the place of the capital investment required by the Act of Congress. Here Congress had supplied the test, and, of course, such test governed; in the case at bar, the test was not supplied, the question was left for determination by local law, and to that law we must look.

That this may produce a lack of unformity, as it certainly does, is immaterial. It did not prevent the Texas lessor or assignor from paying stamp taxes, when his neighbor in Oklahoma did not; it did not prevent the Missouri citizen from escaping the estate tax on certain real estate, when the Texas citizen did not; nor did it prevent the lessee of University of Texas lands being taxed upon his income therefrom, when the lessee of Oklahoma School lands was exempted. Nor will it prevent Congress, if it sees fit to do so, from limiting the scope of the Capital Gain Section and, in the future, excluding from its benefits transactions like those here involved—

---

[1]We do not see how this can be construed as a refusal to follow the local law as contended by the Petitioner (p. 30, Petitioner's brief).

as it did in the Missouri situation dealt with in *Crooks v. Harrellson.*

> "The answer to such argument, however, is, that the constitutional requirement of uniformity is not intrinsic, but geographic. * * * And differences of state law which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity. *Florida v. Mellon*, 273 U. S. 12."[1]

Poe v. Seaborn, 283 U. S. 101.

We turn to some of the other cases cited in the *Hirschi* and similar decisions.

The first of the cases ordinarily relied upon by the opposition is *Stratton's Independence v. Howbert*, 231 U. S. 399, decided December 1, 1913. The facts and questions there presented are entirely different from those at bar. Stratton's Independence was a mining company conducting mining operations on lands owned in fee. The Act involved was the 1909 Corporate Excise Tax law. The case came to this Court on the following certified questions:

> "(a) Did the Act apply to mining companies?
>
> (b) Are the proceeds of ore mined from its own premises income to the mining company within the terms of the 1909 Act?

---

[1]See, also, *Phillips v. Commissioner*, 283 U. S. 589 (602), where the Court said: "The extent and incidence of Federal Taxes not infrequently are affected by differences in State laws; but such variations do not infringe the constitutional prohibitions against delegation of the taxing power, or the requirement of geographical graphical uniformity."

(c) If so was the Company entitled to deduct as *depreciation* the value of the ore in place before it was mined? (Note that the right to deduct cost of the ore in place as depletion was not involved).

This Court said that mining companies were within the terms of the Act, and that they were doing business so as to come within the terms of a tax levied upon the right to do business in a corporate capacity, that the proceeds of the ore mined were undoubtedly "gross income" within the definition of the statute.

In passing upon the depreciation question, the Court pointed out that the Company had deducted from gross receipts the moneys expended in extracting, mining and marketing the ores and "the precise difference was taken to be the value of the ores when in place in the mine." The Court pointed out how this disregarded the cost of the property, and the fact that many times the original cost or market value might be yielded, and disregarded, also, the fact that the Act was designed for practical revenue purposes. Next, it was stated that it was improper, assuming depletion should be taken into consideration, to estimate its amount by the method used—selling price less cost of extracting and marketing. The Court then refused to go further into the question of depreciation. (Three Justices dissented on the third question).

It is impossible to read into this decision anything which has any bearing upon the question at bar—Does a land owner sell property when he executes an oil and gas mining lease? We are not here concerned with the income derived from producing oil—or the depletion and

depreciation deductions to which a producer is entitled, nor do we contend that producing oil—or selling any property for more than cost—does not produce taxable income.

Stanton v. Baltic Mining Co., 240 U. S. 103, next in point of time in this series of cases, arising under the 1913 Income Tax law, insofar as it was not disposed of by the decision in *Brushaber v. U. P. R. Co.*, 240 U. S. 1, dealt solely with whether the asserted inadequacy of the depletion allowance of 5 per cent made by the Act rendered the tax imposed by the 1913 Act a direct tax not on income and, hence not within the 16th Amendment. The Court disposed of this by saying it was fallacious to assume that the tax would be such a direct tax unless adequate allowance were made for depletion because:

> "Independently of the effect of the operation of the 16th Amendment, it was settled in *Stratton's Independence v. Howbert*, 231 U. S. 399, that such tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations."

Von Baumbach v. Sargent Land Company, 242 U. S. 503 (1917) is another case arising under the 1909 Excise Tax law, and involved corporations owning the fee to mining lands and receiving royalties under leases, most of which were in existence when the corporations took title to the lands. The first question presented, whether the corporations were organized for profit and "doing business," can have no application. The other questions were whether the payments received constituted "gross

income" or represented the conversion of capital into money, and, if income, whether the corporations were entitled to a depletion deduction.

In discussing the first phase of this question, while the Court referred to the holdings of the Minnesota Courts (where the property was situated) and the Courts of Pennsylvania upon the nature of mining leases, and the estates conveyed, the Court refused to base its decision upon the holding of Minnesota Courts that the payments were rents, saying that the decisive question was whether the payments were income under the 1909 Act. In holding that they were, the Court refused to distinguish, for the purposes of that case, between a lessor and owner-operator, and, upon the authority of *Stratton's Independence* and *Stanton v. Baltic Mining Company*—held such payments to be income. The depletion deduction was likewise denied. The Court recognized that equitable considerations supported the argument that such an allowance should be made, but refused to extend the "depreciation" allowance made by the Statute to cover the depletion of ore reserves.

Here, again, there is nothing touching the points we are considering. The only question which could have any application here, "whether, in considering this Federal Statute, we should be constrained to follow the established law of the State, *as is contended by the Government*, we do not need to determine."

The last of these cases, *U. S. v. Biwabik Mining Company*, 247 U. S. 116, likewise an excise tax case, dealt with a mining lessee of Minnesota property. The Com-

pany had paid a certain sum for a lease upon the property. As of January 1, 1909, it revalued the ore in place. By dividing this cost and value with estimated reserves, it arrived at two units, one of .038885 and one of .44865 per ton. In its 1910 Excise Tax return, it deducted "to cover realization of unearned increment" the sum of $265,372.08, arrived at by multiplying the sum of these two units by the quantity of ore mined in that year. The trial court upheld the company's right to deduct the amount based upon the cost of the lease, but denied the remainder. The Circuit Court reversed this and allowed the full deduction. The Supreme Court refused to follow the reasoning of the Circuit Court, saying:

> "The lessee takes from the property the ore mined, paying for the privilege so much per ton for each ton removed. He has this right or privilege under the form of lease here involved, so long as he sees fit to hold the same without exercising the privilege of cancellation therein contained. He is, as we held in the *Sargent Land Company* case, in no legal sense a purchaser of ore in place."

The Court did not pass upon, due to the Collector's failure to take a writ of error from the trial court's decition, the correctness of the trial court's holding as to the deduction based upon cost.

This case, at the most, can only be said to hold that the lessee, like the lessor, was not entitled to deduct the value, above cost, of ore in place at the beginning of the year in arriving at net income. The State law, by which title to ore in place did not pass to a lessee, was used as an additional reason for denying the claim. That it did

not control is demonstrated by the fact that the same deduction was denied to a lessor and an operating owner, both of whom did, under applicable State law, own the ore in place.

Indeed, it supports Respondent, in that State law upon the subject of the ownership of ore as between lessee and lessor was used as at least one reason for the decision. By no effort can it be tortured into an approval of that State rule, or an announcement that, under general law, this Court would reach the same conclusion.

Work v. Mosier, 261 U. S. 352-358, cited by the Government as authority for the proposition that the cash bonus or consideration paid for the execution and delivery of the oil and gas lease is to be considered as advance royalty, was and is in no sense authority for the Government's contention in this case.

Work v. Mosier was a mandamus case filed by certain members of the Osage Tribe of Indians, under an Act of Congress June 28, 1906, as parents of certain children, to compel distribution under that Act, of money including their respective shares of bonus moneys paid the Secretary for oil leases made by the Tribal Council. The act was entitled "An Act for the Division of the Lands and Funds of the Osage Indians in Oklahoma Territory, and for other purposes." This Act provided for the enrollment of the Tribe, including minors, and for the division of the land between them by selection, the selection for the minors being made by their parents, but forbade the sale of the oil, gas, coal or other minerals covered by the lands, the minerals being reserved

to the use of the Tribe for a period of twenty-five years, the royalties to be paid to the Tribe. The Act directed that the gas and other minerals named should become the property of the individual owner of the land at the end of that period, unless otherwise provided. Section 3 of the Act directed the leasing of oil and other mineral rights in these lands by the Tribal Council under such rules and regulations as the Secretary might direct and with his approval, provided, "that the royalties to be paid to the Osage Tribe under any mineral lease so made shall be determined by the President of the United States." The opinion was written by Chief Justice Taft, who, among other things, said:

> "The questions presented are, first, the proper classification of bonuses under the statute; second, the validity of the conditions imposed by the Secretary on the payment of the minor's incomes to the parents, and third, the propriety of mandamus as a remedy in this case.
>
> "The bonus which was the result of bidding for desirable oil and gas leases secured for the members of the Osage Tribe the just value of the use of their property which the fixing of royalties in advance by the President was not adapted to give them. It was in effect a supplement to the royalties already determined. It was really part of the royalty or rental in a lump sum or down payment. We do not see how it can be classified as anything else. It was income from the use of the mineral resources of the land. Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the produce of the mine. What was in-

tended to be distributed to the members of the tribe was the income from the mineral deposits in their lands and the bonus was part of that. Doubtless Congress had in mind regular royalties; and did not anticipate such large down payments. But in the unexpected event we must decide under what head the bonus is to be treated, whether as capital or income, and it seems clear to us that, in view of the entire statute, it is more aptly described by the latter term."

Further in the opinion (p. 360) he expressly recognized that the bonuses were given for the mineral leases:

"He was led to take this action, which was a departure from the previous practice of the Department during the decade immediately following the passage of the act, because of the sudden increase in the income of the minors resulting from the bonuses given for mineral leases."

The opinion of the Supreme Court recognized further that the bonus moneys were distributed *merely as* royalties under said Act in the use of the following language:

"* * * including their respective shares of bonus moneys distributable as royalties under said Act."

In other words, under that particlar Act, the Court was confronted with an unexpected contingency arising under the law—the large bonuses received for the leases under competitive bids—something not contemplated by the Congress. Under this unexpected condition which had arisen, it was necessary for the Court to classify such bonuses. It is clear that these bonuses were paid as the

consideration for the execution and delivery of the leases and, in fact, had no relation to the royalties thereafter to be paid, if any, and the learned Chief Justice, when met with this contingency, was required, in solving the problem, only to ascertain from an examination of the whole Act, and all of the circumstances, whether these receipts were of the character which Congress wanted distributed currently, and to the tribe as a whole, or held for twenty-five years and distributed to individual allottees.[1]

We submit that at every point the decision in *Hirschi v. United States* either runs counter to later express pronouncements of this Court, or bases its conclusions upon matters which were not really at issue and had no bearing upon the result.

Little more can be said of the other cases dealing with the same question. *Burkett v. Commissioner of Internal Revenue*, 31 Fed. (2d) 667, by the Eighth Circuit holds that bonuses received for oil and gas leases on lands in Arkansas are not to be taxed as capital gain. There the Court said:

> "The wording and the legislative history of section 206 are clear that it was intended to apply to 'sales' in the sense of conveyance of title to property, not of the creation of privileges or estates or rights in property for a limited period of time."

When this quotation is related to the law of Arkan-

---

[1]The Court's attention is directed to the treatment of *Work v. Mosier* in *Ferguson v. Commissioner of Internal Revenue*, 45 Fed. (2d) 573, 576.

sas, where the Courts apparently treat such instruments as creating a privilege, it is apparent that there is nothing in this statement which conflicts with the Respondent's position in the case at bar. The opinion contains nothing else other than a brief reference to *United States v. Biwabik Mining Company* and *Von Baumbach v. Sargent Land Company.*

Berg v. Commissioner, 33 Fed. (2d) 641, by the Court of Appeals of the District of Columbia, and likewise involving lands in Arkansas, deals with the question somewhat more fully. Again the Excise Tax and 1913 Income Tax cases, heretofore fully discussed, were cited and the opinion concluded:

> "We hold accordingly that the income of appellants under the leases in question was received as rent or royalty, and not as the purchase price of oil or gas produced from the lands by the lessees. The receipts, therefore, were not to be taxed as gains from the sale of capital assets, but as ordinary income under the Revenue Act of 1921."

In neither of these cases is the question discussed as fully as in the *Hirschi* case, nor are any new reasons advanced in either for the holdings there made, and it is important to note that each follows the law of the State as to the effect of an oil and gas lease.

In earlier proceedings, the case of *Alexander v. King* has been cited. This is by the Tenth Circuit Court and is reported in 46 Fed. (2d) 235. The question there presented was whether or not the proceeds derived from month to month by a lessor from the retained royalties

in an oil and gas lease on lands in Oklahoma were capital gains. There the Court expressly recognized the principle upon which our position is based. It was there said (p. 238):

> "The petitions allege that the income arose from 'the sale of oil and gas produced' which had been owned by them for more than two years. Plaintiffs did own the land, or mineral rights therein, for more than two years; but did they own the oil thereunder until it was reduced to possession which was within two years? The answer must be found in the decisions of the Supreme Court of California. *Poe v. Seaborn*, 282 U. S. 101; *Crooks v. Harrelson*, 282 U. S. 55."

The Court then went on to point out that under the decisions of Oklahoma:

> "the plaintiffs did not own the oil before it was reduced to possession; their ownership of the soil arose within the two-year limitation of the Statute, and they are not entitled to exercise the election afforded by Section 206 of the Revenue Act of 1921 or by Section 208 of the 1924 and 1926 Acts."

In no case, we submit, has it been more clearly recognized that the answer to the question must be found in State law.

Two other cases frequently cited may well be discussed together. One is the case of *Rosenberger v. McCaughn*, 25 Fed. (2d) 699, decided by the Third Circuit, and *Bankers' Pocahontas Coal Company v. Commissioner*, 55 Fed. (2d) 626, decided by the Fourth Circuit.

In the first case the taxpayer had inherited an in-

terest in a tract of land in Pennsylvania, which had, in 1881, been leased for coal and from which, in 1917 and 1918, substantial royalties were received. She refused to return any part of these sums for taxation and the Commissioner of Internal Revenue then required her to pay taxes upon the net income received by her. This was represented by

> "The difference between the total amount she received and the capital value as of March 1, 1913, according to the rule for determining income from mining laid down in *New Creek Co. v. Lederer*, 295 Fed. 433."

She took the position that because, under the law of Pennsylvania, the coal lease made by her ancestor constituted a sale of the minerals in place, she was, by virtue of her inheritance, only collecting deferred payments on the purchase price, which were not income. This position was, of course, denied. The Court injected into the case the question of the effect of State rules of property, but finally reached the conclusion that:

> "We think each payment represented in some measure both capital and increment, capital because it stood in the place of coal and increment because in the payments running through ninety-nine years interest on the capital must inevitably have been included, and that this increment or interest was a gain 'derived' within the generalization of the statute 'from any source whatever' and was income in substantially the sense of *New Creek Company v. Lederer*, 295 Fed. 433. The plaintiff can very properly demand that the capital included in her proceeds from mining shall not be taxed. *U. S. v. Ludey*, 274

U. S. 295. But when the capital in the proceeds has been determined and set aside the balance is income and the very thing on which the Government lays its hand and exacts a tax."

Substantially the same situation is revealed in the *Bankers' Pocahontas Coal Company* case. That corporation was the fee owner of lands in West Virginia, which had been leased long before it acquired the land in 1912 for coal. Its contention was that:

> "These contracts, executed in the years 1901 and 1902, and acquired by it in the year 1912, were sales of coal in place that were fully complete before the 16th Amendment went into effect, and that the royalties received during the period 1922 to 1926 were merely payments of obligations that existed unconditionally on March 1, 1913, and were not income taxable under the Federal Revenue Acts."

This contention was, of course, based upon the proposition that under the law of West Virginia the leases constituted sales of the coal in place. The Court referred to *Rosenberger v. McCaughn*, supra, to State Rules of Property and many other cases, including the Excise Tax and 1913 Income Tax cases heretofore discussed. It appears that the taxpayer took the position that *Crooks v. Harrelson*, *Poe v. Seaborn* and *Tyler v. United States* represented a reversal of this Court's previous position in *Weiss v. Weiner*, and the other cases referred to, as to the effect of State law upon Federal tax questions, and in dealing with this contention, the Court said:

> "But it is obvious that each of these decisions turned upon the fundamental question whether the

> property sought to be taxed came within the purview of the taxing statutes. When it was clear that such was the case, the federal statute was given effect; as in *Tyler v. U. S.*, 281 U. S. 497. * * * In the other cited cases, on the other hand, property was held to be excluded from the tax proposed because it did not come within the terms of the statute, and this conclusion was maintained although it was occasioned by observance of a state rule of property, and it was clear that the ruling would bring about a lack of uniformity in the incidence and operation of the tax in different states by reason of diversity of local property rules. The Supreme Court has never abandoned the rule as to the effect of state decisions on questions of property; but it has held in some instances that state decisions do not cover the whole ground to which the federal taxing statutes relate, and, in other instances, that the statutes or decisions of the state lay down rules which define and limit the property which Congress has undertaken to tax."

And the Court upheld a tax on the difference between the royalties received and their March 1, 1913, value.

It may be fairly said, it is submitted, with respect to these last two cases, that, basically, they do not involve the question with which we are concerned, and that in each case the Court went out of its way to surmount difficulties which did not exist. We submit that, in each of these cases, it did not make the slightest difference in the result whether the leases were considered sales of ore in place, grants of privilege or anything else. In practical effect, each taxpayer was, on March 1, 1913, entitled to receive, over a long period of time, periodic non-interest bearing payments—the exact amount of which could not

be definitely ascertained. And it is equally apparent that whether this right had arisen from an absolute sale of the entire fee, or from a rental contract, or from any other source, there was a substantial value on March 1, 1913, in this right to receive payments, but this substantial value was much less than the ultimate receipts over the period of years, for the simple reason that no deferred obligation, which is non-interest bearing, can be worth it face value or the amount ultimately received in later years. Therefore, when each royalty payment was received, subsequent to 1913, there was an element of interest or enhancement in each payment and likewise an element of capital representing the March 1, 1913, value. The March 1, 1913, value, under the Statute, and perhaps under the Constitution, was to be returned tax free, and this was done, and the remainder was to be taxed as income. It is obvious, we submit, that the result would have been the same, regardless of State law, and that the discussion of that question was unnecessarily injected into these cases.

The true situation, we submit, is practically parallel with that dealt with by this Court in *Burnet v. Logan*, 283 U. S. 404, where a taxpayer, who had inherited shares of stock in a corporation in 1917, was held entitled to apply all of the proceeds derived from the sale of the stock (the sale price being fixed in part by a certain sum per ton of ore mined from minerals in which the corporation had an interest) until there was restored to her her capital investment in the property. Cf *Burnet v. Houston*, 283 U. S. 223.

That the Fourth Circuit did not intend, in the *Bank-*

ers' Pocahontas Coal Company case, to announce a rule different from that here urged, but considered the question there presented a different one, is clearly shown by its opinon in *Leser v. Burnet*, 46 Fed. (2d) 756. The question there presented was whether a power of appointment was a general or special power. If the power was general, the property subject to the power situated in Maryland was to be included in the gross estate of the decedent exercising the power; if special, it was not to be so included. The language used in creating the power would have created, in most jurisdictions, a general power, in that it would have conferred authority to appoint the property in favor of the donee's own creditors, but in Maryland the rule was different and it required there additional language to confer this power and create thereby a general power. The Court said upon this point (p. 760):

> "We come, then, to the question as to whether the power created by the conveyance of Charles Carroll Fulton, the language of which we have quoted above, is a general power within this meaning of the act of Congress. This is to be determined by the law of Maryland; for, while we look to the federal decisions, and in the absence of such decisions, to the general law, in interpreting the act of Congress, we look to the law of Maryland as laid down by its courts to determine the effect of conveyances executed within that state and relating to property there situate. *Tyler v. U. S.*, 281 U. S. 497; *Warburton v. White*, 176 U. S. 484. And under the law of Maryland it seems to be well settled that language such as that contained in the Fulton conveyance does not confer upon the donee of the power the right to exer-

cise same in favor of his own creditors. The language used in that conveyance, it is true, is such as in most jurisdictions would be held to create a general power with right in the donee to exercise it in favor of his creditors; *but we are concerned, not with what meaning and effect would be given that language generally, but with what meaning and effect is given it by the Maryland law as laid down by the courts of that state.* Under their decisions, the language used creates, not a general power, but one limited to the extent that it may not be exercised by the donee for his own benefit or for the benefit of his estate or of his creditors. In other words, it creates a mere naked power from which neither the donee nor the creditors of his estate can profit."

We may safely assume that this Court did not, when it decided the *Bankers' Pocahontas Coal Company* case a few months later, intend to depart from the rule so clearly and accurately expressed in the quotation above set forth, for it neither cited nor in any other way referred to its previous decision, and made no attempt to distinguish between the *Leser* case and that.

Tyler v. U. S., 281 U. S. 497, is not, it is submitted, an authority for Petitioner. On the contrary it, with *Burk-Waggoner v. Hopkins*, supra, furnishes an excellent illustration of a principle contended for by the Respondent—the distinction between the tests to be used to determine what Congress can do, and to determine the altogether different question of what Congress has done.

The *Tyler* case dealt solely with the constitutionality of that portion of the Revenue Act of 1916 (Sec. 202 (c)) which required the inclusion, in the net estate of a dece-

dent subject to the Estate Tax, of all property held by the decedent and another "as tenants in the entirety" as was not shown to have belonged originally to the other person and never to the decedent. The express intent of Congress to measure the tax in that way was recognized, and the Court proceeded to deal with "power" instead of "intention."

Referring to the decisions of Pennsylvania and Maryland, where the property was situated, as to the nature of the estate, the Court recognized that such decisions established "a state rule of property, by which, of course, this Court is bound. *Warburton v. White*, 176, U. S. 484, 496." The Court then examined the real basis of the tax, found that death was the "generating source" from which the authority to impose the tax took its being, and the question was not whether there had been, strictly, a "transfer" but whether death had "ripened for the survivor, property rights of such a character as to make appropriate the imposition of a tax upon the result." It is clearly inferable from the opinion that, had the question been whether a "transfer" had been made, the holdings of the state courts would have concluded the matter. And, to determine whether rights had been ripened by death, the Court examined the rights and privileges which the surviving wife had before and after her spouse's death—which rights were fixed and determined by, and could only be ascertained from, state law—and finding that the death of one spouse increased the rights and privileges of the survivor to an extent warranting the tax, upheld it.

The Court in this case did not think, we venture to

assert, that it was limiting the Federal Taxing power when it recognized that State rules of property were binding everywhere, and when it looked to the actualities as disclosed by State rules, to determine, in measuring the power of Congress to make the challenged levy, whether substantial rights had been generated by death.

This case, we again urge, illustrates the correct doctrine. The State law furnished the answer to such questions as to what rights and titles the spouses had in the property before the death of one and what rights and titles accrued to the survivor. This Court accepted the answer so found, and then reached its own independent determination as to whether these were sufficient to support the levy. If any other method had been followed, it is clear that a tax might have been collected upon the determination by this Court that the surviving spouse had certain rights and, when, after paying the tax, she returned to the state where the property was located, and attempted to exercise those rights, she would find that the State Court, the final arbiter on the question, refused to allow her those rights.

Again, we point out that our question is narrower, that Congress has related the capital gain question to state property rules, and that this Court has expressly adopted, in the *Group No. 1* case[1] the precise rule here invoked for deciding a Federal tax case.

---

[1]The Petitioner quotes from the Government's brief in the *Group No. 1* case (footnote 15, p. 27, Government's brief in this case): "On the other hand, however, where the point in controversy relates to property rights as between two contracting parties, the rule of the local court

CONCLUSION

We submit that the Fifth Circuit Court correctly disposed of the whole question in its opinion in the *Ferguson* case, 45 Fed. (2d) 573, when it said that:

> "Congress could, if it saw fit, declare what was meant (by the word 'sale') and the Federal Courts are not bound by the decisions of the state on questions of general law. But the word 'sale' seems to have the same meaning wherever used, and, as to the interest or title which was conveyed by the transfers, we think reliance must be had upon the law of Texas."

When to this is added the observations made by the same Court in this case (R. 20-21) that this Court has held that "an oil and gas lease constitutes a present sale of the oil and gas in place, under the Constitution and laws of Texas," referring to the *Group No. 1* case, and that "It is no new doctrine that a rule of property prevailing in a state, and changes in that rule, will be rec-

---

will be followed in the Federal Courts." In this case the two contracting parties are Respondent and his so-called lessees. The controversial point is whether by the contract property right passed and, if so, what those rights were. We submit that here, again, is a concession of the very point upon which we rely.

ognized in administering the Federal Income Tax law"; the contentions of the Petitioner are effectively answered.

We respectfully submit that the judgment of the Court below should, therefore, be affirmed.

Respectfully submitted,

ROBERT ASH,
WASHINGTON, *D. C.*,
Attorney for Respondent.

A. H. BRITAIN,
LESLIE MARTLEW,
HARRY C. WEEKS,
WICHITA FALLS, TEXAS,
Of Counsel.

APPENDIX

Excerpts from Regulations 65 relating to income tax under the Revenue Act of 1924:

"Art. 201. DEPLETION OF MINES, OIL AND GAS WELLS; DEPRECIATION OF IMPROVEMENTS.—Sections 214 (a) (9) and 234 (a) (8) provide that tax payers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. See Section 204 (c) and Article 1602 with reference to the basis for computing depreciation and depletion.

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) the cost of his property, or (b) the value of his property on the basic date plus, in either case, subsequent allowable capital additions (see Article 224), but not including land value for purposes other than the extractions of minerals. See Section 204 (c) and Article 1602.

"Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a mining or oil or gas corporation is not allowed such deductions.

"When used in these articles (201-239) covering depletion and depreciation—

"(a) The term 'basic date' indicates the date of valuation, i. e., March 1, 1913, in the case of property

acquired prior thereto, if the cost was less than the fair market value on March 1, 1913; the date of acquisition in the case of property acquired on or after March 1, 1913, or in the case of property acquired before March 1, 1913, if the cost of such property was greater than its fair market value on March 1, 1913; or the date of discovery, or a date within 30 days thereafter, in the case of discovery."

* * *

"Art. 203. AMOUNT RETURNABLE THROUGH DEPLETION AND DEDUCTIONS IN CASE OF LESSEE.—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

"(2) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

"(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is (1) its cost or (2) the value of his interest in the mineral as of that date, whichever is greater.

"(d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost.

"(e) The value of a lessee's equity in a discovery after February 28, 1913, is the fair market value at date of discovery or within 30 days thereafter, of his equity in the mineral discovered.

Art. 216. DEPLETION—ADJUSTMENTS OF ACCOUNTS BASED ON BONUS OR ADVANCED ROYALTY.—(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition. * * *"

Treasury Decision 3938 (Cumulative Bulletin V-2):

"TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
WASHINGTON, D. C.

"*To Collectors of Internal Revenue and Others Concerned:*

"Article 215 of Regulations 45 (1920 edition), Article 215 of Regulations 62, and Article 216 of Regulations 65 are hereby amended to read as follows:

"Art. 216 (215). *Depletion — Adjustment of Accounts on Bonus or Advanced Royalty.* — (a) Where a lessor receives a bonus in addition to royalties, there shall be allowed a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received. * * *

"All rulings inconsistent herewith are hereby revoked.

D. H. BLAIR,
Commissioner of Internal Revenue.

"Approved November 13, 1926.
A. W. MELLON,
Secretary of the Treasury."

Regulations 71, revised July, 1932, relating to stamp taxes under the Revenue Act of 1932:

"Art. 84. *What Constitutes Real Property Determined by Law of State Where Located.*—(a) What constitutes 'lands, tenements, or other realty' is determined by the law of the State in which the property is situated. Standing timber is ordinarily held to be real estate, and where so held the deed transferring it is subject to the tax.

"(b) In states where common-law dower still exists an instrument purporting to convey the inchoate right of dower of a wife or the consummate right of

dower of a widow, prior to assignment of dower, is not subject to stamp tax; but an instrument conveying the estate acquired by a widow upon assignment of dower is subject to tax. Where by statute dower has been abolished and a different interest in the husband's real property conferred upon the wife in lieu thereof, the taxability of an instrument purporting to convey such an interest prior to its assignment will be determined by the nature of the wife's interest, and the statutes and decisions of the particular State in which the real estate is located must be consulted."

The regulations adopted to enforce similar provisions of the Revenue Acts of 1918, 1921 and 1924 were identical.

RULING OF TREASURY DEPARTMENT UNDER THE STAMP TAX PROVISIONS OF THE REVENUE ACT OF 1932—holding that oil and gas leases on Texas lands, and assignments thereof, are subject to stamp tax:

"TREASURY DEPARTMENT
WASHINGTON
Aug. 12, 1932

Office of
Commissioner of Internal Revenue

MT:ST:WLM

Mr. A. H. Britain,
Wichita Falls, Texas.

Sir:

Receipt is acknowledged of your letter of July

12, 1932, concerning the taxability of an oil and gas lease styled 'Producers 88 Special Form Texas Lease' under Section 725 of the Revenue Act of 1932.

"You are advised that Section 725 imposes a tax on any instrument whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to a purchaser or purchasers. That which constitutes lands, tenements, or other realty is determinable by the laws of the State in which the property is situated.

"The instrument submitted by you provides that the party of the first part, called the lessor, does 'grant, demise, lease, and let unto' the party of the second part, called the lessee, certain land 'for the sole and only purpose of mining and operating for oil and gas, and laying pipe lines, and building tanks, powers, stations, and structures thereon to produce, save, and take care of said products.' It is agreed that the lease shall remain in force for a term of three years from its date, and as long thereafter as oil or gas, or either of them is produced from the land by the lessee.

"In Liberty Central Trust Co. v. Gilliland Oil Co., the District Court of the United States, Northern District of Texas, held that the interest of a lessee under an oil and gas lease was subject to assessment for State and county taxes. In reaching this opinion the Court said: 'That the lease is a conveyance of the land as well as the right to use it for an undeterminable period of time; the lessee by reason of the instrument has exclusive dominion over the oil and gas therein found and this dominion and ownership is as effective as though the oil were described in

gallons, texture, fineness, and color, and the gas in cubic feet and volatility.'

"In view of the above facts it is held that the instrument submitted by you constitutes an interest in real property and is therefore subject to the tax imposed by Section 725 of the Revenue Act of 1932. The assignment of such lease conveying the same interest, which is created by the lease, is also a conveyance of an interest in realty and subject to the tax under the same provisions of the Act.

Respectfully,

(Signed) R. M. ESTES,
Deputy Commissioner.

"MBC:RL
cc-Dallas, Texas."